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Special bulletin no. 07 (1920, December); Inventories, commitments and foreign exchange

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SPECIAL BULLETIN No. 7

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INVENTORIES, COMMITMENTS AND FOREIGN EXCHANGE

Q. I should be much obliged if you could give me the views of some leading New York accountants on the treatment of inventories and contracts for forward delivery at the end of the year.

A. By the courtesy of a New York firm of accountants we are able to present as an answer to the above question a memorandum of a discussion prepared by the firm for the use of its own offices dealing with the questions of inventories, commitments and foreign exchange.

The problems of inventories, commitments for purchases of goods at prices in excess of market and foreign exchange, which were recognized as to some extent inter-related, were discussed at length.

The subjects were considered in relation to

(a) Treatment in books.
(b) Treatment for tax purposes.
(c) Statement in published accounts.
(d) Form of certificate to be given.

Inventories:

The question was discussed at length whether the present reduction of prices was likely to be temporary. It was agreed that prices were in many cases below cost to some producers. It was felt though that there must be a reduction in the standard of living in some parts of the world for some years, and this must mean that until reduction of production takes place there would be excess supply, so that prices would not be governed by cost until some of the higher cost producers, being eliminated, production and demand should be more nearly equalized.

It was agreed, therefore, that it would not be sound to treat present declines as purely temporary.

It was agreed that it would be in order to show operating profits on the basis of inventories at cost (less usual provisions for obsolete stocks, etc.), and the adjustment from cost to market as a special charge either against profits or surplus, provided that the procedure adopted was clearly disclosed. In point of fact, the loss from the decline of prices is an offset to the extraordinary profits from increasing prices realized over a series of years and not an operating loss of the year. But as the extraordinary profits in past years have been included in the ordinary profits, any statement this year must either similarly absorb the corresponding decline or show clearly that this decline has not been absorbed in the operating results.

It was considered that clients generally should and would agree to the cost or market, whichever is lower, basis for their published accounts. It was pointed out that the Internal Revenue Department permitted this principle to be carried to the length of taking goods in process and finished goods at values based on current values of basic raw material. It seemed that in principle this could be supported only on the theory that a specification cost based on current costs in all respects represents the present market value on a reproduction basis. It was not felt that the department would be prepared to go this length or that clients generally would wish to do so, but as the logical result of the department's rules it seemed permissible. It was felt that clients practically had an option whether they would or would not adjust basic raw materials in work in process and finished goods in making cost or market adjustments.

The question of goods purchased in foreign markets was considered. Persian carpets were taken as an illustration. The market in Persia has declined slightly, and the value of the Persian kran has declined about 50 per cent. It was agreed that market in such cases means to importers the present Persian price converted at the current exchange rate.

The treatment of inventories by companies having contracts for sale of goods at prices yielding a profit above cost was considered. It was agreed that where goods have been bought specifically for such contracts, they should be taken at cost even if that be higher than market, both for general accounting and tax purposes. This should apply only if the contracts are enforceable contracts with responsible people—not in cases where enforcement would involve such risk of a bad debt as to be unwise. It was recognized that the question as to applying goods on hand to such contracts where they were not earmarked was difficult, and the firm should not be disposed to question any reasonable course adopted by any client in this matter.

The question whether cost cards should be adjusted was discussed. It was felt that clients should have something in the nature of a detailed inventory in which individual items would be reduced to market, so as to produce it to the Internal Revenue Department, but that subject to this requirement it was not necessary, nor probably desirable, to adjust inventory cards. In some cases, however, it might be convenient to make adjustments as at the close of the year and reverse them in the new year.

For tax purposes clients might be well advised to adhere to cost, if adjustment to market would mean converting small profits into losses or increasing losses. In such cases adjustment to market for general purposes could be effected by reserves. It was agreed that there was little prospect of legislation permitting recovery of 1919 taxes on account of 1920 losses, but a fair chance of the enactment of provisions permitting losses to be carried forward and applied against future profits in some way.

Commitments:

It was agreed that disclosure of the fact that a concern has commitments for future purchases at a cost substantially in excess of present market values is a material factor in its financial position unless it has offsetting sale contracts with responsible purchasers. The treatments were considered in order of preference:

(1) A reserve for loss on such commitments, which, if earmarked, may be included in reserves and not treated as a current liability.

(2) A footnote showing the difference between purchase cost and market value of such commitments.

(3) A note that there has been no provision for such difference.

In cases 1 and 2 an unqualified certificate can be given. In case 3 the certificate should state that *"subject to the fact that as stated in the balance-sheet no provision has been made,"* etc. This qualification seemed necessary, since the amount of the difference is a material fact and is not disclosed.

For tax purposes it is clear that no deduction in respect of the difference between market values and the purchase price of goods contracted for but not delivered can be made. Where, therefore, companies face a loss, and desire to take it in 1920, they must take appropriate action before December 31st. This can be done in various ways, including

a. Expediting delivery of the goods so as to bring them into the inventory at December 31st.
b. Making a payment to secure a cancellation.
c. Transferring the contract or selling firm for future delivery an amount equal to the amount for which contract has been made.

It was thought the second method mentioned could not be objected to even if contemporaneously the contractors should enter into new contracts for similar goods at lower prices.

It was pointed out that while methods 1 and 2 might be attractive to companies which had large profits and wished to bring in losses to offset them, the other parties to the contracts might also in some cases have large profits and be unwilling to bring additional profits into 1920. It was suggested that this would be particularly true in regard to sugar contracts. It was felt that the third alternative would meet such a situation adequately.

The question was raised whether there was any moral objection to the course suggested, and it was considered that as there was a loss to be faced on the goods, and as the cause of that loss was the action of buying in 1920, there could be no moral or legal objection, provided that the company established the loss by action of a definite and final character in 1920.

It was recognized that with many companies the tax consideration and the financial or credit considerations would operate in opposite directions, but it was felt that on the whole the companies would be well advised to take their losses and save the taxes, especially as all credit granting institutions would be sure to inquire very closely into the question of obligations in respect of such commitments.

Foreign Exchange:

In regard to the question of exchange it was agreed that the soundest conclusions would be reached by regarding foreign currencies as commodities. When an American concern sells a product that has cost a certain amount of dollars for a certain amount of, say, marks, it exchanges one commodity for another, and the ordinary way of determining the profit is by taking the commodity received (the marks) at its face value at the date of acquisition. Once the marks are in stock they must be carried in accordance with the ordinary inventory practice at cost or market, whichever is lower. Viewed from this angle there can be no question of loss on exchange at the time of sale. On the contrary, to take the marks in at par would obviously be to take up an unrealized and improbable profit. The only question of exchange loss is in relation to the decline in value between the date of the original sale and the end of the year.

On the whole it was agreed that current assets and current liabilities must be treated in a consolidated balance-sheet, or for purposes of valuing foreign investments at current rates of exchange at the close of the year. It was agreed that in some cases it might be permissible to show an extraordinary loss on exchange as a separate item in the profit and loss account, but that the amount so to be shown would require to be very carefully considered.

It was pointed out that great care should be taken in adopting the above principles not to apply them to foreign currency items which represent conversions of American dollar values, such as the f. o. b. value of goods of American origin. Obviously this item should be converted back into dollars at the same rate as was applied to the original conversion.

Foreign Drafts:

The New York partners mentioned that cases on a large scale had arisen in New York where exporters had shipped goods with sight drafts attached to territories such as Cuba and South America, and the consignees had refused to accept either the goods or the drafts. It was agreed that in such cases the sale was not completed and no profit should be taken for tax purposes, but the goods treated as inventory and valued at cost or at their market value on the spot where they happened to be. It was agreed that this treatment should also apply to goods in transit as to which the time had not arrived when the consignee would be called upon to accept the draft or the goods. The view was expressed that comparatively few of these cases would arise at other offices than New York, and it was suggested that any offices encountering such cases should communicate with New York in regard thereto.